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18 October 2023

By email: superannuation@treasury.gov.au

EY Submission
ED law - Proposed additional 15% tax based on individual's superannuation balances

Dear Director

Ernst & Young (EY) is pleased to provide comments in response to the exposure draft law (ED) released for consultation on 3 October 2023 which sets out proposals to impose an additional 15% tax on certain individuals' 'earnings' where they have total superannuation balances (TSBs) greater than $3 million (proposed new Division 296 and associated amendments in draft *Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023* and *Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023*).

We are concerned that the Government has not made any adjustments to the policy underlying the proposed measures following feedback on the announcement and the subsequent consultation paper and in particular that this new tax as proposed in ED will still:

- Tax the unrealised gains of assets in an impacted superannuation fund
- Apply more broadly than was announced by the Government's as the superannuation fund balances of a much greater population grow to more than the unindexed $3 million TSB threshold.

As an advisor to a broad range of individuals and self-managed super funds (SMSFs) that will be impacted by the proposed changes, we are concerned what financial impacts the changes will have and what additional costs of compliance will be created.

In particular, impacted individuals who have legitimately invested in certain asset classes through superannuation and who now want to move those assets outside their fund (where a preservation condition has been met) in response to the policy will incur costs such as stamp duty and legal and accounting fees for advice and related services from such a transfer. This is in addition to any capital gains tax considerations within the fund from such transfers.

We are further concerned of what overall effect the policy announcement will have on the general wellbeing of Australia's superannuation system, in particular:

- There is risk that continued further changes to the taxation of superannuation such as this will undermine the Australian public's views on the benefits of contributing to superannuation and that this will discourage the optimal use of the system in an environment which is intended to encourage the self-funding of retirement income.

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- The fact that people's perception of the superannuation system is not restricted to those who might be subject to the new tax either on commencement or some time in the future (noting various commentary that the application of the rules will be much broader than initially expected by Treasury). This raises concerns that this change may be only the start of yet a further broader round of changes to the superannuation tax system in the short or medium term.
- The interaction of the new tax with various other existing policies and concessions which encourage the transfer of wealth into the superannuation system in particular and circumstances which may result in "buyer regret" where they are used and this contributes to the new 15% tax being applied (on increases in value from such contributions), including in respect of concessions such as:
    - Downsizer contributions from the proceeds of selling a person's main residence, especially given the potential in the current Australian capital city market for significant sale prices
    - Small business CGT roll-over into superannuation and the retirement exemption.

Specific concerns

We outline in the Appendix a number of specific concerns with the proposed additional tax, with recommendations:

- We are concerned with the impacts that may arise as a result of the proposed taxation of unrealised gains - we recommend an alternative approach to determine earnings should be explored.
- We recommend that the TSB $ 3million threshold should be indexed to account for changes in the value of money over time – we recommend the approach used to index the transfer balance cap should be adopted for this purpose.
- Further detail is required as to how the new TSB value will be determined and the drafting of these rules must consider and minimise any additional costs of compliance – we recommend consultation on these rules should occur as soon as possible.
- In addition to the modification where the prior year TSB is $3 million or less, we recommend the additional 15% tax rate should only apply where the average of TSB is more than $3 million over the current and previous year.
- The proposed negative superannuation carry-forward approach will result in many unfair outcomes. We recommend an option to carry back negative earnings at a proportional rate for prior years and to receive a refund of the tax paid in respect of that earlier year should be included.
- We recommend the Government should consider how a combined TSB threshold could be applied for spouses or include a mechanism for spouses to transfer a certain portion of their TSB to their partner.

We do not address any specific issues for large funds in this submission, but we note that these funds may also be impacted by the new definition of TSB and any additional reporting that might be required for the measure.

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Should you have any queries or would like to discuss our submission in further detail, please do not hesitate to contact Kim O'Brien in our Private Tax group (kim.obrien@au.ey.com or 02 9248 4474) or Brian Lane in our Tax Policy group (brian.lane@au.ey.com or 03 8650 7250).

Yours sincerely

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Appendix – Specific Issues

Taxation of unrealised gains as part of earnings

The calculation of "superannuation earnings" for the measure using movements in an individual's total superannuation balances (TSBs), as adjusted, will mean that unrealised (notional) gains and losses on assets held in the superannuation fund(s) are included in these earnings.

We are concerned that the proposed taxation of unrealised gains may result in:

- Volatility issues – fluctuations in the value of assets may not be able to be predicted as reliably as income from those assets, resulting in unexpected higher tax bills in a year and potentially lower or no tax in a subsequent year, creating uncertainty and potentially suboptimal investment of fund assets to account for the volatility as well as potential unexpected liquidity issues
- Liquidity issues where a significant proportion of assets such as real property assets or other illiquid investments are held by the individual and fund - may force individuals, or where they choose to pay the tax from their superannuation fund, the fund, to dispose of illiquid assets to cover the tax on earnings with costs incurred including brokerage and legal and accounting fees for advice and which forced disposal may be against the fund's investment strategy or risk profile
- Poor fund outcomes - depending on the nature of the assets, the timing of the disposal to realise these assets in time to meet the tax due may result in less than ideal sale proceeds which will adversely impact the value of the fund and erode member benefits
- Increased tax calculated on a year by year basis compared to taxing the ultimate gain on disposal - an asset may ultimately be realised for a lower value than at the time the earnings were taxed, whether due to changes in market or macroeconomic conditions. At this point, tax has already been imposed on the earlier value increase *even though* the value of the underlying assets is ultimately lower than when the earnings were calculated. (See also our concerns below where there are ultimate negative earnings.)
- Further, the proposed changes do not recognise the potential eligibility for any CGT discounts which may apply to capital gains on underlying assets held through the superannuation fund (although we recognise that this is part of the design of the rules to keep them simple and minimise compliance costs).

We recommend that alternative legislative responses should be considered that avoid the taxation of unrealised gains while not significantly increasing superannuation funds' costs of compliance.

Need for indexation of TSB threshold

It is proposed that the TSB large superannuation balance threshold (TSB threshold) will be fixed at $3 million. The threshold therefore does not account for the effects of inflation and corresponding accretion in the underlying value of assets held in superannuation funds, even over the medium to long-term. In addition, it does not account for the future impact of increased employer contributions arising due to increased wages over time due to CPI and inflation.

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Whilst the ED acknowledges that the proposed changes will affect "around 80,000 people, or approximately 0.5 per cent of Australians with a superannuation account in the 2025-26 income year", the additional tax will over time affect a greater proportion of individuals which may go beyond the intended policy of the measure.

We recommend that the $3 million threshold should be indexed. We suggest that the indexing methodology applied for the purpose of the transfer balance cap (section 960-285 ITAA97 and section 960-265 table item 10A) should be considered as an appropriate method. This approach is intended to only adjust the base on an annual basis where a significant movement in the consumer price index (CPI) has incurred, by increasing the cap only in increments of $100,000 rounded down to the nearest $100,000.

New TSB value

The ED proposes to replace the known current definition of total superannuation balance (TSB) with a new definition, described as the "TSB value" in the ED, for the 15% tax calculation and also for all other uses of this amount from 1 July 2025.

The new TSB amount is either:

- Determined by a method or value prescribed in the regulations; or
- Otherwise the total amount of the superannuation benefits that would become payable if an individual had the right to cause the superannuation interest to cease at that time and the individual voluntary causes the superannuation interest to cease, colloquially known as the "withdrawal benefit" (draft EM para 1.27)

We are concerned that the ED does not include any further detail as to what is the method which would be required to determine the value or what the "specified value" of the TSB is.

In particular, we are concerned what additional costs of compliance may arise to taxpayers including additional costs of obtaining valuation and other advice to comply with the requirements.

This creates uncertainty and means we cannot provide appropriate feedback on this proposal.

Further, the inclusion of regulations later by legislative instrument made by the Minister may not result in the same level of scrutiny of these rules compared to the rules being included in the Bill or being consulted on at the same time as the Bill.

We recommend that the proposed methodology and other rules for valuing the TSB should be released for consultation as soon as possible, in particular for unlisted assets held in the superannuation environment.

Rules should not apply where average TSB <$3m

We welcome the modified calculation in a year where the TSB balance has increased from less than $3 million at the end of the prior year to be more than $3 million at the end of the year, to calculate earnings on only the amount of the increase above $3 million.

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However we submit that the proposed additional tax should operate as a tax on yearly "earnings". We note that the approach of adjusting the opening balance to $3 million for the earnings test may still result in inappropriate outcomes if the excess balance over $3 million at year end is attributable to increases in value which occur shortly before that time.

We recommend that in addition to the proposed modification, the additional 15% tax rate should only apply where the average of TSB, calculated over the current and prior year as (TSB end of the previous financial year + TSB end of the current financial year)/2, is more than $3 million.

Negative superannuation earnings

If an individual has negative superannuation earnings in a financial year, it is proposed that this can be carried forward to reduce the superannuation earnings and therefore the Division 296 tax liability in future years.

This approach will result in many unfair outcomes where Division 296 tax has already been paid on increases in the TSB calculated on the basis of unrealised gains of assets in the fund for prior years where those gains may not or do not eventuate.

Excessive tax may be payable:

- Where an asset has increased in value over a number of years but is now valued at a lower value resulting in negative earnings and there is not sufficient earnings in future years (or not for a number of years) to offset that amount against.
- Where an asset has increased in value over a number of years but is ultimately sold for a lower value (including at a loss), resulting in negative earnings and there is not sufficient earnings in future years (or not for a number of years) to offset that amount against.

The tax may be excessive because:

- Tax is payable in the years when the value increases, at an increasing proportional rate.
- The negative earnings may then be available for offset in subsequent year at a lower proportional rate due to the decline in value associated with the negative earnings.
- Overall the tax over those years may be higher than it would be on the overall gain to the fund.
- If the individual's TSB drops below $3 million for a number of years and potentially indefinitely there will therefore be no future Division 296 superannuation earnings to offset the negative earnings against.

An example of a particular unfair outcome which may arise is if an investment asset which has increased in value and therefore has contributed to a Division 296 tax liability in a year is liquidated in a future year where the resulting loss on the investment creates or adds to negative earnings under the Division and that negative amount is not utilised for a number of years or is never utilised if the individual's TSB falls below and remains below the $3million threshold.

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Simple example
(assumes no contributions or withdrawals)

Year 0	Year 1	Year 2	Year 3 (and later
Asset held Asset value $1m TSB $3m	Asset increases in value Asset value $1.5m TSB $3.5m "Earnings" $500k Division 296 tax = $10,500	Asset liquidated for $100k consideration Asset value $0 + $100k cash TSB $2.1m Transferable negative superannuation earnings = -$500k	No further contributions Other asset value increase but TSB remains below $3m Cannot utilise negative earnings amount

We recommend that an option to carry back negative earnings at a proportional rate for prior years and to receive a refund of the tax paid in respect of that earlier year should be included.

Imbalance in TSB between spouses

In the self-managed superannuation fund context, it is highly possible that one spouse may have a TSB exceeding $3 million and the other spouse may have a TSB less than $3 million, in particular, in those families with fund balances accumulated before the then Government's 2016-17 Budget Superannuation Reform Package of superannuation measures that were implemented from 1 July 2017.

The couple will have proceeded on the legitimate basis that they would access their combined superannuation balances. Under the proposed amendments, the partner with a TSB greater than $3 million would be disproportionately affected by the additional 15% tax compared to if the couple had instead evened out their balances as between them over time (including before the 2017 changes). We submit that this is a harsh outcome.

For example if Spouse A has a TSB of $3.5m and Spouse B has a TSB of $500,000 then Spouse A will be subject to the additional 15% tax. If the balances between the spouses had been equalised ($2m each) than neither would be subject to the tax.

Treasury should consider how a combined TSB threshold could be applied for spouses, to ensure there is fiscal neutrality in how the family group is treated relative to individuals.

Alternatively, the Government should consider including a mechanism for members within the family group to transfer a certain portion of their TSB to their partner, although this would need to be subject to certain integrity measures.

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